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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC No. 93-253

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FCC MAIL SECTION

In the Matter of	)	
	)	
Regulatory Reform for	)	
Local Exchange Carriers	)	CC Docket No. 92-135
Subject to Rate of Return	)	
Regulation	)	

REPORT AND ORDER

Adopted: May 13, 1993; Released: June 11, 1993

By the Commission: Commissioner Duggan concurring and issuing a statement.

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I. Introduction

1. In this Order, we take significant steps to improve the way we regulate rates for approximately 1,300 small and mid-size local exchange carriers (LECs). This group of smaller carriers represent the approximately 6 percent of LECs whose rates are not regulated pursuant to price cap regulation, i.e., that remain subject to traditional rate of return regulation. While these carriers vary widely in size, ownership patterns, and capital investment, in comparison to price cap LECs, they represent only 7.6 of the total access lines, 5.3 percent of the total access minutes, and 6.3 percent of the total industry revenue requirement.

2. These smaller carriers face increased challenges on a number of fronts. Neighboring Bell Operating Companies compete for customers with new services and repackaged existing services. Changing regulatory requirements, such as the Commission implementation of Open Network Architecture and requirements for expanded interconnection, create new expectations from customers and increase the demand for quality service and responsiveness. Finally, new technologies, in particular those offered by neighboring exchanges, increase the LECs' need for regulatory flexibility and the ability to respond to competitive service offerings.

3. In the wake of the Commission decision to adopt price cap regulation for the largest LECs, these small and mid-size carriers asked for regulatory methods more attuned to their diverse needs than the price cap system. This Order provides a package of three regulatory alternatives that small and mid-size companies can use to succeed in an evolving telecommunications marketplace, and that at the same time provide incentives to offer high quality service efficiently, and at reasonable cost to ratepayers.

4. In our small and mid-size LECs Notice of Proposed Rulemaking[1] we discussed the diversity of small and mid-size LECs and the challenges to designing improved regulatory mechanisms for these carriers. We tentatively concluded that the preferred approach to regulatory reform for this segment of the LEC industry is a continuum of increasingly incentive-based approaches which permits a company to select a plan best fitting its circumstances. At each point along this continuum, we proposed regulatory reforms to foster efficient investment decisions, and to provide companies with more flexibility to meet changing market conditions than they now have under existing rate of return regulation. At each step along the continuum of regulatory approaches, business risk would increase, as would the possibility for increased rewards in the form of potential earnings growth and reduced administrative burdens. In addition, under each approach ratepayers would be protected because efficiency gains would be passed along to ratepayers periodically in subsequent tariff review periods.

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[1] Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, 7 FCC Rcd 5023 (1992)(hereinafter NPRM); 7 FCC Rcd 5501 (1992)(Erratum).

5. The record in this proceeding supports this approach. The rules we adopt here are largely as proposed in the NPRM with changes as supported by the record. These rules shall become effective 30 days after publication in the Federal Register.[2]

6. In this Order, we adopt new tariff rules to implement regulatory reform for small and mid-size LECs that remain subject to rate of return regulation. First, a new, optional, incentive-based plan is adopted which permits carriers to establish rates based on their historical costs. During the new two-year period before rates are revised, incentive plan carriers will be permitted to retain higher earnings than those that utilize prospective cost estimates in their ratemaking processes. The incentive plan also permits limited pricing flexibility and streamlined treatment for the introduction of new services in some situations. Second, we adopt rules that expand the scope of our existing small company rules by allowing LECs serving 50,000 or fewer access lines to file annual common line rates based on historical cost. Third, we amend our rules to permit carriers that do not elect to participate in the incentive plan or the small company rules to file tariffs every two years. Otherwise, we have left this baseline regulatory treatment of rate of return regulated carriers unchanged.

II. Background

7. The LEC Price Cap Order[3] mandated that seven Regional Bell Operating Companies and the General Telephone Operating Companies file interstate access rates based on price cap regulation. All other carriers could choose to file rates based on price caps, but once they chose price cap regulation they could not return to rate of return regulation. Price cap regulation took effect for the largest LECs on January 1, 1991.[4] Six other large LECs have elected to become subject to price caps.[5] As a result, a substantial majority of interstate

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[2] See 5 U.S.C. § 553(b)(B).

[3] See Second Report and Order, 5 FCC Rcd 6786, 6827 (1990) and Erratum, 5 FCC Rcd 7664 (1990) (Com. Car. Bur.) (LEC Price Cap Order), modified on recon. 6 FCC Rcd 2637 (1991), petitions for further recon. dismissed, 6 FCC Rcd 7482 (1991), upheld on appeal, National Rural Telecom Association v. FCC, Nos. 91-1300, 91-1303, 91-1304 and 91-1326, slip op. (D.C. Cir. Mar. 26, 1993), further modified on recon. 6 FCC Rcd 4524 (1991) (ONA Part 69 Order), petitions for recon. of ONA Part 69 Order pending, appeal docketed, D.C. PSC v. FCC, No. 91-1279 (D.C. Cir. June 14, 1991).

[4] Id.

[5] All LECs with more than 1 million access lines and fourteen of the sixteen LECs with more than 500,000 access lines are subject to price cap regulation, two of which elected price cap regulation this year.

access customers are now served by companies regulated under a price cap regime.[6] With the largest LECs subject to price caps regulation, the remaining companies, subject to rate of return regulation, are fairly characterized as small and mid-size carriers.[7]

8. Of the LECs that remain subject to rate of return regulation, almost all participate in the traffic sensitive, carrier common line and end user common line pools administered by NECA. In a pooling environment, rates are based upon the total costs and total demand of all participating companies. Each company receives its actual costs, plus its share of the pool's earnings. The major reason companies want to participate in pools is to share risks, by providing a high degree of assurance that the company will recover its costs. The rates for these pools and other small and mid-size company tariffs under Section 61.38 of the Rules are based on projections of the LECs' costs and demand.[8]

9. Smaller LECs do not want to become subject to price cap regulation for numerous reasons. Many believe that they cannot abandon the risk sharing provided by the NECA pools and Long Term Support protection, which maintains a common line rate equivalent to a national average common line rate, without substantial risk to their continued financial viability. Others believe that, because of their small size, their business cycles are too long to comply with price cap's annual adjustments and that the financial effect of facility upgrades is too great to be reconciled with in the Commission's price cap framework.

10. The LEC Price Cap Order stated that the Commission would "initiate further proceedings dealing specifically with regulatory issues of concern to small and

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[6] Companies under price caps regulation represent 92.4 percent of the total access lines. Approximately 94.7 percent of the access minutes are provided by price caps companies. Price caps companies generate 93.7 percent of the total LEC industry revenue requirement. (1990 NECA data filed with the Commission).

[7] Most small companies, those with fewer than 50,000 access lines who are also part of NECA Subset 3, are locally owned and operated LECs, organized as closely held corporations, cooperatives or mutuals. The "mid-size" companies, with between 50,000 and approximately 1 million access lines, generally have multiple telephone company subsidiaries. The stock of larger mid-size companies is often publicly traded. For the most part, these companies operate in more than one state.

[8] Of the 1308 local exchange study areas that are not subject to price cap regulation, 1184 are included in the NECA traffic sensitive pool; and 1253 are included in the NECA common line pool. Thirty-nine small companies maintain traffic sensitive tariffs under Section 61.39 rules, outside of the NECA pool. 650 study areas are served by average schedule companies. 243 of these companies are cooperatives. (National Exchange Carrier Association Description and Justification, Annual 1993 Access Tariff Filing, Transmittal No. 546, filed april 2, 1993, at 2 and 11).

mid-size LECs."[9] The Order committed to examining regulatory options that "recognize the unique circumstances" facing smaller LECs.[10] Finally, the Order resolved to continue to examine small company issues "to ensure that desirable regulatory reforms are applied to small telephone companies as far as possible and applied with sensitivity to their special circumstances."[11] This docket is one of the vehicles that responds to the directives of the LEC Price Cap Order.[12]

11. In the LEC Price Cap Order, the Commission adopted an annual productivity growth standard of at least 3.3 percent, after inflation, as the basis for setting maximum rates for all price cap LECs. In exchange, the plan grants those carriers the opportunity to earn significantly higher profits as an incentive for even greater productivity gains, as well as greater rate flexibility and lower regulatory requirements than under rate of return regulation. Price caps was made mandatory for the large LECs: the Bell Operating Companies and the General Telephone Operating Companies. Recognizing the varied conditions and characteristics of small and mid-size LECs, the Commission permitted those companies the option of remaining under rate of return regulation or enrolling voluntarily in price caps. We also indicated that we would explore ways to adapt the efficiency incentives of price caps to the needs of small and mid-size LECS.[13]

12. We presented an optional incentive regulation plan in the NPRM that initiated this docket. Essentially the incentive plan is a form of lagged rate of return regulation which allows LECs the opportunity to earn higher profits if they can improve efficiency above their historical performance during a two-year rate period. At the end of that period, rate levels are retargeted to the rate of return prescribed by the Commission. The plan sets no specific productivity target, as price caps does, but the carrier is rewarded if it can improve its productivity, because it is allowed to retain higher levels of profit than is allowed under rate of return regulation. Ratepayers benefit from the efficiency gains achieved by the carrier, because these are flowed through into lower rates in the next rate period by the retargeting.

13. As set out in the NPRM, the optional incentive plan offers small and mid-size LECs lower potential rewards than full price caps, commensurate with the lower risks incentive plan LECs would assume. For example, price cap LECs are permitted to earn up to 12.25 percent before sharing half of returns, and up to

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9 LEC Price Cap Order, 5 FCC Rcd 6786, 6827 (1990).

10 Id.

11 Id.

12 See also Amendment of Part 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, 7 FCC Rcd 4688 (1992) (exploring streamlining and improvement of the method by which an authorized rate of return is selected).

13 LEC Price Cap Order at 6827.

16.25 percent before 100 percent sharing occurs.[14] The NPRM proposed the incentive plan LECs be permitted to earn up to 1 percent above the prescribed rate of return, which is currently 11.25 percent. By comparison, carriers subject to rate of return regulation are permitted to earn only 1/4 of one percent above the prescribed rate of return, on a total interstate basis. We also proposed giving incentive plan LECs greater flexibility in setting rates, based on service baskets and bands similar to those in price caps.

14. For LECs choosing to remain under baseline rate of return regulation, we proposed to reduce regulatory burdens by moving from annual to biennial tariff filing schedules and to simpler methods of projecting costs and demand. In addition, we proposed to expand the simplified filing options for small LECs contained in Section 61.39 of our Rules,[15] currently applied only to traffic sensitive rates, by adapting them to carrier common line rates as well.

15. Taken together, this range of regulatory approaches was intended to assure reasonable rates while reducing regulatory burdens and introducing or expanding incentives for efficiency and innovation. Overall, the record developed in this docket strongly supports all of these initiatives. In the remaining sections of this Order, we discuss the revision we are making to various details of the proposals set out in the NPRM as they were presented in comments or by our own ongoing review of our small and mid-size LEC regulations.

III. Optional Incentive Regulation Plan

16. Our price cap system was designed for the largest carriers with the benefit of a long history of carrier-by-carrier oversight and experience. This detailed knowledge of each subject carrier's costs and pricing history enabled the design of an incentive program linked directly to each carrier's prices. Because the vast majority of smaller carriers have participated in the NECA pools, we do not have for them the same company-specific experience. Therefore, in designing an incentive-based regulatory system for the smaller carriers, we have designed a system linked to each company's historical costs rather than price. In a rate of return context, the incentives are established by reliance on historical costs and an extended tariff period. Such reliance is traditionally referred to as "regulatory lag." Because rates are reestablished every two years, this system encompasses less risk than price caps. Accordingly, we have designed a system with less potential reward than price caps.

17. The optional incentive plan we adopt today will be available to any non-price cap LEC for either its traffic sensitive rates only, or for both its traffic sensitive and common line rates. In comparison to current rate of return regulation methodology, the optional incentive plan incorporates longer tariff periods, greater reliance on historical costs, broader earnings bands and greater pricing flexibility. Every two years, rates are to be recalculated based upon

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[14] If the price cap regulated LEC accepts a higher productivity factor of 4.3, the carrier is permitted to earn up to 13.25 percent before sharing half of the returns, and up to 17.25 percent before 100 percent sharing occurs.

[15] 47 C.F.R. § 61.39.

costs and demand established during an historical period. During the two years, carriers operating pursuant to this plan would have the incentive to reduce their costs because cost increases will lessen their earnings while cost decreases will permit greater earnings.

A. Tariff Filings: Frequency and Mid-Term Revisions

18. Notice. The NPRM proposed that carriers participating in the optional incentive regulation plan file tariffs every two years. The NPRM tentatively concludes that two year filings would substantially reduce regulatory burdens, simplify the tariff review process, while permitting the Commission to scrutinize rates to meet our statutory obligations under the Communications Act to ensure rates are reasonable. More significantly, the NPRM tentatively found that an extended tariff period provides sufficient regulatory lag to create incentives for companies to manage their costs.[16] The NPRM asked whether companies electing to participate in the optional incentive plan should be permitted to file mid-term revisions. The NPRM proposed that carriers making such mid-term filings only if rates fall 100 basis points, or 1 percent, below the authorized rate of return, which is currently 11.25 percent. We also requested comments on permitting adjustments for cost changes that would render rates unreasonable, suggesting that incentive plan LECs might be required to bear a heavy burden of proving that cost changes had rendered their rates unreasonable.[17]

19. Comments. Several parties[18] generally agree with the tentative conclusion that the optional incentive plan reduces regulatory burdens for smaller LECs.[19] The ICC further asserts that increasing regulatory lag by one year provides additional incentives for innovation and efficiency.[20] No party opposed the two-year tariff period, or suggested a different period.

20. With regard to mid-term tariff revisions, the ICC argues that, since the regulatory lag is increased by one year under the proposal, it is appropriate to impose a higher burden of proof to justify mid-term changes. According to the ICC, the efficiency gains are maximized when prices are held constant.[21] USTA argues that, for mid-term filings within the two-year tariff period, the

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16 NPRM, 7 FCC Rcd at 5025.

17 Id. The NPRM reasoned that, if mid-term filings are permitted without also demanding that the carriers bear a heavier burden of proof than in routine tariff filings, the incentives for efficiency created by reliance on historical costs and a two-year regulatory lag are substantially reduced.

18 The full names of commenting parties and abbreviations used in this Order are listed at Appendix A.

19 ALLTEL Comments at 4; see also, Lincoln Telephone and Telegraph Company (Lincoln) Comments at 3, GVNW, Inc./Management (GVNW) Comments at 2.

20 ICC Reply at 3; accord SBA Comments at 11.

21 ICC Reply at 4; accord Taconic Comments at 7.

LEC should not be required to meet a heavy burden of proving that its existing rates are unreasonable. USTA asserts that imposing a high standard on mid-term filings would make the optional incentive plan more risky than price cap regulation, which provides for yearly automatic rate increases if carriers earn below 10.25 percent.[22] USTA suggests that we permit companies to use a rate adjustment factor to retarget their rates to allowed earnings limits within the two-year period.[23] ITAG contends that the burden of proof in a mid-term filing should recognize the difficulties small and mid-size carriers have in managing costs and reacting to demand changes.[24] Centel argues that limiting tariff revisions to a biennial filing may be unlawful under the Communications Act, which establishes a system of carrier-initiated rates.[25]

21. Discussion. We agree with the commenters that requiring tariff filings every two years under the incentive plan will substantially reduce regulatory burdens and will enhance the incentives carriers have to manage costs and stimulate demand to maintain or improve earnings.[26] Under current rate of return practice, all rate of return carriers file annual tariffs, updating their rates to be effective each July 1.[27] By requiring these filings only once every two years, the administrative burdens on the carriers will be substantially reduced.

22. A more significant issue is how difficult it should be for LECs to change rates in the middle of the two-year period. If carriers electing this plan are free to increase rates during the two-year period, their incentives to improve efficiency are severely reduced. Allowing carriers under the incentive plan to

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[22] USTA Comments at 21, citing LEC Price Cap Order, 5 FCC Rcd at 6802; see also Centel Comments at 4; PRTC Comments at 7-8; Lincoln Comments at 3-4 (arguing for 14 days' notice); JSI Comments at 3-4; SBA Comments at 12; ITAG Comments at 3-4.

[23] USTA Comments at note 50; see also Centel Comments at 3.

[24] ITAG Comments at 4-6 (arguing that costs associated with 800 database and SS7 demand levels, largely governed by interexchange carrier competition, and increased competition for exchange services contribute to the difficulty in predicting rates for a two-year period).

[25] Centel Comments at 3, citing AT&T v. FCC, 487 F.2d 865 (CA 2d 1973); MCI v. FCC, 765 F.2d 1186 (D.C.Cir. 1985). Concluding that the effect of such rules would be to freeze rates, the court in ATT v. FCC held that this is the same as prescribing rates, which the Commission can do only after hearings have been held and the prescribed rates found to be just and reasonable. AT&T v. MCI at 874-875.

[26] But see MCI Reply at 6-8 (arguing that the Commission should undertake an in-depth analysis in an attempt to ascertain the small LECs' long term productivity and place certain categories of LECs in specific risk/reward incentive regulation plans). We affirm the conclusion of the NPRM not to take a price cap approach to introducing incentives to rate of return carriers.

[27] 47 C.F.R. § 69.3.

increase rates freely also undercuts the rationale for permitting LECS to retain higher earnings. The incentive plan is a voluntary plan under which the LEC accepts greater risks than under cost-plus, baseline rate of return regulation in order to be permitted to achieve greater rewards, but only if it improves its productivity.

23. Nevertheless, in unusual cases, unexpected events may cause unusually low returns that justify rate increases. To address those cases, we believe a mechanism similar to the lower formula adjustment in price caps should be applied. As adapted to the incentive plan, if after one year the LEC makes an adequate tariff showing that the optional plan limits have caused rates to fall below a zone of reasonableness, and this trend is likely to continue through the two-year rate period, we will permit the LEC to adjust rates upward. In order to preserve the plan's incentives, we will consider requests for upward mid-course rate revisions only if the LEC has fallen more than 0.75 percent below the prescribed rate of return and will permit rate increases only to the extent necessary to bring earnings to that same level during the second year of the rate period. Finally, we will continue to permit LECs subject to the incentive plan to request rate adjustments targeted to the authorized rate of return if the LEC can show that rates are otherwise confiscatory. We will expect the LEC to bear the burden of demonstrating that the optional incentive plan, including the lower rate adjustment, will not permit it to set reasonable rates. Any such filings will be subject to special scrutiny and a high probability of suspension and investigation. LECs will be required to submit detailed cost support, in accordance with the most recent Tariff Review Plan, to support any mid-term filing. They should also provide a detailed explanation of why existing rates, based on adjusted historical costs, are likely to be unreasonable.

24. We do not find this plan, as USTA argues, to be more onerous than price cap regulation. Unlike the price cap rules, incentive plan LECs are not required to lower rates relative to inflation by at least 3.3 percent annually. In addition, incentive plan LECs will have their rates aligned to revenue requirements every two years. Therefore, the incentive plan places far less risk on LECs than does the price cap system. Moreover, for those carriers that are unwilling to accept the more moderate risks established by the incentive plan, more traditional rate of return tariff filing requirements remain available to them.

25. Biennial filings will also permit us a better opportunity to review rates for reasonableness, in compliance with the Communications Act. As previously established in Section 61.39, two year filing periods are sufficient to ensure interstate rates remain reasonable. We find that biennial filings, punctuated by cost-based review of revenue requirements and rates, and supplemented by our authority to investigate rates on our own motion or pursuant to complaint, are a lawful exercise of our statutory discretion to tailor our regulatory systems. Since we are not precluding mid-term revisions, the optional incentive plan does not contradict the statutory system of carrier-initiated rates.

B. Earnings Band

26. Notice. The NPRM proposed to establish an earnings band for carriers that elect the optional incentive plan. This band is set to recognize that

there is less risk associated with the incentive plan than is inherent in price caps, yet greater risk than involved in traditional rate of return regulation. Therefore the incentive plan should permit lower earnings than price caps, yet a broader band than is currently used for rate of return regulated carriers.[28] Specifically, the NPRM proposed a band that extends 100 basis points, or 1 percent, above and below the authorized rate of return, currently set at 11.25 percent. Unlike the price cap band, this band would adjust with any rate of return represcription.[29]

27. Comments. The ICC argues that a band of allowable earnings is preferable to a single-point rate of return because it creates incentives for the LEC to be more efficient and innovative in order to achieve greater earnings.[30] AT&T generally supports the proposed earnings band.[31] AT&T argues that the plan limits LEC risks because "access rates would be retargeted biennially to the LECs' authorized rate of return, mid-term adjustments to the lower earnings band would be permitted, and LECs would retain the option to revert to traditional rate of return regulation."[32] MCI asserts that no LEC has provided any showing that the level of risk inherent in the incentive plan justifies increasing the level of reward. Therefore, MCI contends, the Commission should not blindly expand earnings zones.[33]

28. USTA argues that the proposed upper limit on earnings for the incentive plan is far lower than that of price caps and fails to consider the inherent risk of the proposed incentive plan.[34] USTA states that, when the LEC retargets its rates to the authorized return level at the end of the two-year period, based on historical data, there is a significant chance that the LEC will not reach its authorized rate of return if its costs increase faster in the subsequent period than does demand. USTA also asserts that the likelihood of such a risk occurring increases as the LEC participates in the plan for multiple two-year periods.[35] Finally, USTA contends that the rewards of the plan are limited because all benefits of efficiency gains, other cost savings and demand

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28 NPRM, 7 FCC Rcd at 5025.

29 Id. at ¶ 12.

30 ICC Reply at 4.

31 AT&T Comments at 3.

32 AT&T Comments at 4; see also SBA Comments at 15, stating that it "generally backs the encasement of incentive regulation within the integument of rate-of-return regulation for smaller LECs."

33 MCI Reply at 5.

34 USTA Comments at 11-12; see also ALLTEL Comments at 4-5; Lincoln Comments at 4-5; PRTC Comments at 6-7; Centel Comments at 4-5; GVNW Comments at 2.

35 USTA Comments at 12-13.

stimulation, ultimately flow to the customer due to readjusting rates every two years.[36] Therefore, USTA proposes that carriers under the optional incentive regulation plan be permitted to earn "up to 200 basis points above the authorized level before being required to retarget to the authorized return at the end of each two-year period."[37] SBA suggests a reduction in the lower level to 50 basis points below the prescribed rate of return to give LECs greater assurance that their financial structure will be protected.[38]

29. USTA asserts that AT&T fails to recognize the substantial risks to LECs under the incentive plan. USTA asserts that the requirement that LECs retarget to the authorized return at the end of two years merely limits the carriers incentive potential because all the benefits of efficiency gains ultimately flow back to the access customer.[39] Further, USTA argues, the opportunity to make mid-term revisions will do little to limit a LEC's risks because such adjustments would increase rates only up to the lower earnings band and the LEC must meet a "heavy burden" to justify any rate increase at midterm.[40] Additionally, USTA continues, while a LEC will have the option to return to baseline regulation, this feature does not mitigate the risk that a LEC might not reach its authorized rate-of-return if its costs increase during the plan period faster than demand grows for its services.[41]

30. Discussion. In the NPRM, we tentatively concluded that an approach similar to the price cap earnings band was appropriate for the incentive plan. The price cap plan sought to balance risk with potential reward. We also concluded that, because the risks of the incentive plan are less than those associated with price caps, the rewards of the incentive plan should be less. This rationale is sound and is consistent with our design to establish a regulatory continuum which balances risk and reward. The level of permissible earnings represents a substantial part of the reward equation and deserves careful consideration.

31. We believe that the plan proposed in our NPRM represented a rational balance of risk and reward. This Order makes some adjustments to the plan proposed in the NPRM. As discussed below, we are somewhat strengthening the plan's reliance upon historical costs by disallowing "known and measurable" showings and, as discussed above, by imposing a burden of proof that rates are unreasonable for mid-term corrections. Therefore, it is reasonable to increase the earnings potential of the plan over the 100 basis points proposed in the

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36 Id. at 13-14.

37 Id. at 16; see ALLTEL Comments at 5; JSI Comments at 5; ITAG Comments at 6; PRTC Reply at 3 (supporting USTA).

38 USTA Comments at 16.

39 USTA Reply at 8.

40 Id.

41 Id. at 8-9.

NPRM, and to raise the lower bound of the band above the 100 basis points proposed. Price cap carriers are permitted to retain earnings of up to 200 basis points above the initially prescribed level without triggering the sharing mechanism. We believe that matching this level for the incentive plan would be unreasonable; however, we also believe that, in light of other changes made in this Order, 100 basis points may be too restrictive. We also recognize that, unlike for price cap carriers, changes in the prescribed rate of return would affect the earnings zone ceiling, and the lower end, for carriers participating in the optional incentive plan. Accordingly, to better balance the risks and rewards of the incentive plan, we increase the permissible earnings zone for incentive plan carriers from a 100 to a 150 basis point maximum for LECs that elect the plan for their traffic sensitive rates only. Because there is less earnings potential under the incentive plan than under price caps, it is reasonable that there be less of a down-side risk. Therefore, we also raise the lower end from 100 basis points below the authorized rate of return to 75 basis points below the authorized rate of return.[42] Finally, we believe this increase is warranted because, to the extent the carriers increase their earnings, the benefit of those earnings is passed to ratepayers in the next tariff filing.

C. Pricing Flexibility

32. Notice. Consistent with the proposal to give optional incentive plan carriers flexibility in pricing new service offerings, the NPRM also proposed some additional pricing flexibility for existing services. The NPRM proposed a basket and service category system defined on the same basis as in the price cap rules. Within each two-year period, aggregate rates for each basket would remain unchanged; however, carriers could adjust rates within each service category by 10 percent up or down over the two-year period, subject to the same reduced notice and support requirements as within-band price cap filings.[43] The NPRM asked whether the rules should establish some lower bound for pricing flexibility beyond 10 percent.[44]

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[42] The NPRM asks whether it is appropriate to require sharing of earnings over the permissible levels for LECs participating in the optional incentive regulation plan. For the present we will not apply a sharing mechanism to the optional incentive plan. One of our goals in this proceeding is to maintain regulatory simplicity to the extent possible. While comments express some degree of interest in a sharing mechanism, there is no compelling argument made which demands that such a mechanism be a part of this regulatory plan. In general, issues pertaining to earnings in excess of the described band should be addressed in CC Docket No. 92-133 exploring streamlining and improving the method by which an authorized rate of return is selected and related enforcement issues.

[43] NPRM, 7 FCC Rcd at 5026.

[44] Id. at ¶ 19.

33. Comments. The LECs commenting on the pricing flexibility support the NPRM proposal.[45] USTA argues, however, that the proposal should be clarified to state that, to the extent a LEC operating under this plan has "flexed" its rates, the existing rate relationships should be preserved at the next biennial filing. As under price caps, flexibility in rate setting should be cumulative, i.e., include a mechanism to smooth the transition from rates "flexed" during the prior tariff period to new rates developed during the retargeting to the authorized rate of return for the next tariff period, according to USTA.[46]

34. MCI contends that it currently takes a price cap LEC a minimum of one year to change the overall rates of a service by 10 percent. Under the Commission's incentive plan proposal, MCI states, a participating LEC could make a 10 percent change in the price of a service all at once. Therefore, MCI urges limiting the incentive regulation LECs' pricing flexibility to 5 percent per year with a cumulative impact up to a maximum of 10 percent over the two year filing period.[47] MCI also opposes USTA's proposal to make the maximum amount of price changes cumulative, arguing that the small LECs are monopolists and have not shown that they face even the very limited competitive pressures that some large LECs face.[48]

35. Discussion. We adopt the proposal to create a limited system of pricing flexibility for carriers operating under the optional incentive plan. Drawing on our experience with price caps, flexibility shall be recognized in the form of a no-suspension zone, within which LECs remain relatively free to adjust prices. These filings would be permitted on 14 days' notice. Should rates move outside the zone, LECs must file the same cost support showings required of price cap carriers for above-band and below-band filings.[49]

36. The differences between price cap regulation and the optional incentive plan, however, require that we modify the no-suspension zone for use here. While we will adopt the same price cap baskets and service categories used in price cap regulation,[50] we will not mandate use of an index to track carrier

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[45] ALLTEL Comments at 6; Centel Comments at 9; Lincoln Comments at 7; USTA Comments at 17.

[46] USTA Comments at 17.

[47] MCI Comments at 3-4.

[48] Id. at 9.

[49] See 47 C.F.R. § 61.49(c) and (d). Above-band filings must be accompanied by supporting materials establishing substantial cause for the proposed rates. Below-band filings must be accompanied by supporting materials establishing that the rates cover the service category's cost.

[50] 47 C.F.R. § 61.42(d)-(g).

prices.[51] Instead, aggregate rates in a basket are based on aggregate revenues at the beginning of each tariff period. Aggregate prices in a service category, however, can decrease or increase by a maximum of 10 percent during the two years between rate filings.[52] The method of tracking prices will be determined in the tariff process.

37. This limited pricing flexibility responds to a variety of concerns that stimulated our re-evaluation of regulation of small and mid-size carrier pricing. First, since price cap LECs have similar rate flexibility, granting limited rate flexibility to carriers under the optional incentive plan helps ensure that small and mid-size companies can respond to pricing actions on the part of their price cap neighbors. Second, carriers regulated under this incentive plan absorb more risk than those regulated under more traditional rate of return. Our decision to employ historical costs, adjusted only by exogenous costs listed in the rules, as well as the creation of a two-year rate period, forces these carriers to manage their costs efficiently. That risk requires that we grant more freedom to manage their business operations. Without some pricing latitude, we will not succeed in creating a workable incentive-based system.

38. We do not believe there are significant advantages to MCI's proposal to limit flexibility to 5 percent per year, over our own proposal to allow 10 percent flexibility for the entire two-year period. MCI's proposal would add a layer of administrative complexity that would undercut some of the incentive plan's goals without apparent benefit. The concerns underlying MCI's proposal, moreover, can be addressed in the tariff review process. We decline to adopt this changes in the plan.

39. We also find that pricing flexibility should be cumulative, i.e., that the rate relationships of "flexed" rates in effect at the end of a tariff period should be used to set rates at the beginning of the new tariff period. Absent this ability, carriers would not have the opportunity to address changing market conditions and moving to more efficient pricing.

D. Cost Support for Incentive Plan Tariffs

1. Basis of initial and subsequent filing

40. Notice. The NPRM proposes basing the first optional incentive plan filing on a cost of service study for the most recent 12 month period together with related demand data for the same period. Subsequent filings would be based on

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51 See 47 C.F.R. § 61.42(d) - (g). The LEC baskets include common line, traffic sensitive switched, and special access. An interexchange service basket would also be created if the LEC provides such services. The traffic sensitive basket includes the following service categories: 800 services; local switching; information; and transport. The special access basket includes: voice grade, WATS, metallic, and telegraph services; audio and video services; high capacity and DDS services; and wideband data and wideband analog services.

52 We borrow subindexes from price caps, as well as any category pricing limits differing from the plus or minus 5 percent rule.

similar cost and demand information for all elements for the period since the time of the carrier's last filing.[53]

41. Comments. ALLTEL supports the proposal to base the first incentive plan tariff filing on the company's costs for the most recent 12 month period.[54] Lincoln proposes that rates in subsequent biennial filings should be adjusted using a cost and demand rate adjustment factor. This factor would prevent possible rate jumps between rates changed through pricing flexibility and those established at the beginning of subsequent tariff periods.[55] AT&T proposes that any LEC selecting the plan must file on the public record a tariff review plan which contains historical cost and demand data underlying proposed rate levels. AT&T notes that these data are routinely generated by the LECs and are essential to verifying the reasonableness of the proposed rates.[56]

42. Centel argues that we should not adopt the proposal to base costs on historical cost and demand. First, it asserts that such methodology is only appropriate for LECs "whose past resembles their future", not for companies like Centel that have operated efficiently in the past but face increasing costs in the future.[57] Centel also contends that the incentive plan's lack of an inflation adjustment requires LECs to absorb all inflation costs which results in a greater risk that a carrier will underearn.[58] Ronan urges that we permit carriers to use the average schedules prepared by NECA as a basis for rate development under the incentive plan.[59]

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[53] NPRM, 7 FCC Rcd at 5025.

[54] ALLTEL Comments at 5. See also Lincoln Comments at 5.

[55] Lincoln Comments at 5.

[56] AT&T Comments at n. 5 (also arguing that tariff review plan material will be essential in establishing compliance with the optional incentive plan's provisions for pricing flexibility and new services). But see Lincoln Comments at 2-3 (arguing that it is no longer appropriate to define regulatory requirements based upon a Tier I and Tier II distinction, noting that the Tier I carriers still under rate of return regulation represent a small portion of the remaining 7 percent of total industry access lines. Therefore, Lincoln argues, the Commission should no longer apply filing and reporting requirements designed for the large carriers, now under price caps, to small and mid-size LECs (i.e., ARMIS, TRP, etc.). Lincoln concludes that the distinction should be merely price cap and non-price cap.

[57] Centel Comments at 6.

[58] Id. at n. 8; accord NARUC Comments at 4.

[59] Ronan Comments at 2-6. Ronan also asks the Commission to provide long term and transitional support payment to small independent LECS that exit the NECA pools and to exempt such carriers from the obligation to pay such support. Finally, Ronan ask that the Commission establish that average schedule companies that leave the NECA pools be permitted subsequently to return to the pools and

43. Discussion. We adopt the proposal in our NPRM to base the first incentive plan filings on cost of service studies and demand studies for the most recent 12-month period. Subsequent filings will also be based on the most recent 12-month period instead of on the period since the time of the carriers last filing. We believe that basing all filings on carriers' most recent 12-month period provides the most accurate data and provides consistency among data submission by LECs, facilitating analysis, review and monitoring. Reliance on historical costs serves two objectives: (1) historical costs reduce administrative burdens by creating cost showings grounded in historical, actual data that are straight forward to produce and explain; and (2) historical costs enhance the optional incentive plan's efficiency incentives by minimizing opportunities for padding costs by over estimating future expenditures or investments. Experience with the price cap plan and the Section 61.39 rules for small companies, both of which rely on historical costs, supports our conclusion here that historical cost showings are preferable to evaluating prospective, projected cost and demand data. For example, rates filed by carriers under Section 61.39 of our rules have been consistently lower than comparable rates filed by NECA.

44. With respect to AT&T's suggestion that we require a tariff review plan to be submitted with each biennial filing, we agree that tariff review plans associated with annual access filings have been a useful and informative means of standardizing the presentation of LEC cost support data. We have, however, considered and rejected codifying the tariff review plan (TRP). Detailed specification of a tariff review plan in Commission rules is unworkable, given the pace of regulatory, technological and competitive changes. The Common Carrier Bureau adjusts the review plan annually to accommodate new or modified requirements, such as the advent of price cap regulation, the implementation of the price cap sharing provisions, and the implementation of Open Network Architecture and database 800 services. While we expect that the Bureau will continue to rely on a standardized review plan, tailored to the various regulatory systems in use, and that the plan will be filed on the public record, we decline to establish formal rules governing the details of the review plan.

45. We also decline to adopt a productivity factor or an inflation factor. Because of the substantial diversity among smaller carriers, it is not possible to establish a workable productivity factor. In addition, providing for inflation alone does not yield a full accounting of external pressures. The incentives of this optional plan are based on regulatory lag and reliance upon historical costs. LECs choosing the plan assume the risks and reward of national and local economic factors on their operations during the two-year rate period. If carriers, such as Centel, believe that their business profile demands such factors, they may choose between our price cap system or rate of return regulation.

46. We decline to adopt the use of average schedule settlements as a surrogate for cost studies under the incentive plan as proposed by Ronan. Average schedule companies may participate in the NECA pools, or may file their own tariffs pursuant to Section 61.39 of our rules. In the latter case, the historical

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retain their average schedule status.

average schedule settlements formulae serve as a surrogate for cost studies. We believe that these options are reasonable and sufficient to meet the needs of average schedule companies, without requiring a conversion to cost. Additionally, as with price caps, the pricing flexibility mechanism and the necessary regulatory oversight of company earnings require actual costs to develop rates.[60]

2. Adjustments to Historical Costs

47. Notice. The NPRM proposed two mechanisms for adjusting historical costs at the time of the biennial filing. Carriers could recognize "known and measurable" costs if the exclusion of such costs would cause the carrier to earn less than 100 basis points below the authorized rate of return. With such a showing, the carrier would retarget rates to earn 100 basis points below the authorized rate of return. Such showing would be subject to a higher burden of proof than would a purely historical cost showing. The NPRM asked for types of costs which would be included as "known and measurable."[61] The NPRM also proposed to permit carriers to recognize costs classified as "exogenous costs" within the meaning of that term in the price cap plan. A carrier could choose to claim exogenous costs either at the time of a biennial filing or at the time the cost occurred during the two-year rate period.[62]

48. Comments. While the proposal to recognize exogenous cost changes drew little comment,[63] the proposal to recognize other "known and measurable costs" created strong differences of opinion. AT&T argues that, if "known and measurable" costs are included initially in a carrier's rates, the carrier's incentive to reduce costs through actual efficiencies is substantially diminished.[64] AT&T further contends that the inclusion of "known and measurable" costs would complicate the implementation of tariffs by permitting the use of a mixture of historical and prospective costs, rather than historical costs alone.[65] To guard against overforecasting of "known and measurable" changes, AT&T argues, there would need to be some form of post-period audit to determine whether these changes actually occurred, at what magnitude they occurred, and

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[60] We also find Ronan's request to extend the benefits of Long Term Support to small companies exiting the NECA pools to be beyond the scope of this proceeding.

[61] NPRM, 7 FCC Rcd at 5026.

[62] Id.

[63] GVNW Comments at 3; ALLTEL Comments at 5 (arguing that exogenous costs be reflected prospectively).

[64] AT&T Comments at 4. See also ICC Reply at 5.

[65] AT&T Comments at 4-5.

whether access customers are entitled to refunds of excessive rates that were predicated on unrealized costs.[66]

49. AT&T argues that in no event should LECs obtain the benefits of rate-of-return regulation through guaranteed recovery of their normal business expenses while at the same time enjoying the generous pricing and earnings flexibility of the optional incentive plan.[67] Other parties contend that "known and measurable" costs are unnecessary in light of the proposal to permit mid-term rate corrections which protect LECs from inadequate earnings while at the same time preserving the LECs' incentives to become more efficient.[68] According to ICC, the mid-term revision is the appropriate forum in which the LEC should argue for recovery of such costs. AT&T argues that the definitions of "known and measurable" offered by the LECs would effectively allow the inclusion of virtually all of the ordinary costs of doing business.[69]

50. USTA argues that under its proposed definition of "known and measurable" changes, only instances where there is an objective confirmation of the future event causing a cost or demand change would qualify as "known and measurable."[70] Accordingly, USTA contends, in view of the high confidence level required of changes considered to be "known and measurable," AT&T's concern that the costs "may not actually materialize during the two-year tariff period" is unfounded.[71] USTA also argues that we should establish a threshold requirement for recognizing "known and measurable" costs: such costs would be included only if, without them, rates would produce earnings at least 100 basis points below the authorized rate-of-return. USTA argues that this threshold should exclude all but the largest "known and measurable" changes from consideration.[72] Finally, USTA argues, the ability to make mid-term rate adjustments does not obviate the need for "known and measurable" changes, particularly under the Commission's proposal which would require a LEC to meet a heavy burden of proving that its current

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66 Id. at 5. See also ICC Reply at 5.

67 AT&T Reply at 4.

68 Id. at 5-6. See also MCI Reply at 7 (supporting AT&T position); ICC Reply at 5.

69 AT&T Reply at 3.

70 USTA Comments at 14; accord Centel Comments at 7; JSI Comments at 5-6; GVNW Comments at 3; Lincoln Comments at 4. For example, if a LEC wanted to (or had to) include SS7 implementation costs in its base period data, the LEC would need a signed contract or other firm documentation evidencing the planned installation of SS7 capability along with the precise costs involved, as well as other applicable showings. Such costs would not qualify for known and measurable treatment merely because the LEC had included the costs in its next year's budget. USTA Reply at 16.

71 USTA Comments at 16-17.

72 Id. at 17.

rates are unreasonable. Further, USTA states, mid-course adjustments would be prospective only, and would prevent LECs from recovering known and measurable changes that occur prior to the mid-course correction.[73]

51. Discussion. We continue to believe that exogenous costs, those listed for price caps in Section 61.45(d) of the Commission's Rules, should be used to adjust the historical costs used in the optional incentive plan. These are basically cost changes associated with Commission programs and rules, or other events outside the control of the LECs. As in the case of price cap LECs, adjustment for these changes should more accurately track costs, without distorting the LEC's incentives to become more efficient in areas that are within its control. Adopting the price cap list of exogenous factors should also be administratively feasible.

52. Upon reflection, however, we believe the arguments raised against adjustments to historical costs for "known and measurable" future events are persuasive. As AT&T points out, review of both the initial amounts of costs assumed to be "known and measurable" and, subsequently, of whether those amounts proved to be accurate, would be necessary but administratively difficult and intrusive. An important advantage of historical costs is to reduce the burdens of reviewing. Adding consideration of claimed "known and measurable" costs would largely forfeit this advantage.

53. Adjustments for "known and measurable" costs are also likely to be unduly favorable to LECs, in at least two ways. First, the potential cost changes that might qualify as "known and measurable" would be best known, and perhaps only known, to the LECs themselves. The LEC would have a substantial incentive in this situation to report only the potential cost increases, not reductions, or to target increases to shortly before the beginning of the rate period, while leaving offsetting savings until after the period had begun. Second, focusing only on cost changes ignores the equally important question of benefits. Introduction of a new capability such as SS7 may increase some costs (such as switching costs) but may well reduce others (such as transmission costs) while allowing the LEC to offer new services and options. Adjusting rules solely for the higher costs without recognizing the offsetting savings and other benefits, would be unduly generous to LECs and unfair to ratepayers.

54. Therefore, we believe AT&T is fundamentally correct, that including "known and measurable" prospective costs would undermine the plan's efficiency incentives. As in the case of price caps, the incentive plan places greater responsibility for operational decisions on the LEC than cost-plus rate of return regulation, while providing incentives in the form of higher profits for good decisions, and disincentives in the form of lower profits for bad decisions. Granting automatic rate adjustments for "known and measurable" changes would substantially eliminate such incentives. We accordingly conclude that the optional incentive plan should not permit adjustments to historical costs for "known and measurable" costs.

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[73] Id. at 17-18. See also PTI Reply at 4-6.

55. In the context of this optional incentive plan, we find that a system which recognizes exogenous cost changes, as defined in the price cap rules,[74] and that permits mid-term filings to correct rates that are unreasonable, strikes the best balance between our efficiency objectives and our statutory obligations to ensure reasonable rates. As in our price cap system, carriers operating under the incentive plan can claim exogenous costs either in the biennial filing or as exogenous costs occur during the two-year rate period.[75] Thus, for the limited class of costs that are defined as exogenous by our rules, LECs operating under the optional incentive plan can recover these costs when they are incurred, and need not wait for the biennial filing. Moreover, unlike the price cap system, which would ordinarily deny rate increases that are above the price cap or pricing band unless based on costs found to be exogenous, the optional incentive system merely delays recognition of such endogenous costs to the biennial cost review.

56. Mid-term tariff revisions provide further assurance that rates are producing reasonable results. While we have necessarily established a higher burden for mid-term filings, the existence of mid-term filings ensures that, for the majority of costs not recognized as exogenous, a sudden increase in costs relative to historical levels can be given early recognition in rates.

3. Carrier Common Line Rates

57. Notice. The NPRM stated that common line rates present a more complicated problem than other rates, because the recovery of common line costs is split between carrier common line rates, which are charged on a per minute basis to interexchange carriers, and subscriber line charge rates, which are charged on a per line basis to subscribers. A further complicating factor is that the amount of the per minute carrier common line charges changes with demand, since common line costs are essentially fixed.[76] We proposed that rates for optional incentive plan LECs be derived using costs from the most recent 12-month

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[74] 47 C.F.R. § 61.45(d). Changes recognized as exogenous under Section 61.45(d) are limited to those cost changes caused by: the completion of the amortization of depreciation reserve deficiencies; changes in the Uniform System of Accounts permitted or required by the Commission; changes in the Separations Manual; changes to the level of Long Term Support or Transitional Support obligations described in § 69.612; the reallocation of investment from regulated to nonregulated activities pursuant to § 64.901; inside wire amortization; and, such tax law changes and other extraordinary exogenous cost changes as the Commission shall permit or require.

[75] As in the price cap system, exogenous cost showings can not be contingent upon a future event -- e.g., the prospect that some cost might materialize due to future Commission action is not sufficient.

[76] NPRM, 7 FCC Rcd at 5028.

period.[77] To derive demand, the company would determine the average carrier common line usage and the percentage growth in usage over the most recent 24-month period. Demand for the rate period would be determined by a simple extrapolation of base period demand increased by base period percent growth.[78] The proposed methodology is consistent with current rate of return practice in which the benefits of demand growth are immediately flowed through to ratepayers. It differs in that rate of return practice permits the use of prospective data, while the proposal for the optional incentive plan relies solely on historical cost and demand. Thus, the LEC has incentives to reduce its costs and stimulate demand growth.

58. Comments. AT&T argues that the proposed method correctly captures prospective demand growth by tying it to actual, historical growth rates rather than speculative projections as to how demand will grow in the future. AT&T also states the proposal will be simple to administer.[79]

59. USTA argues that the application of the proposed formula would result in ascribing the full benefit of growth in common line demand to the LECs' interexchange carrier customers and none to the LECs themselves, which is contrary to the Commission's decision in the price cap proceeding to credit LECs with at least 50 percent of the benefit of demand growth. USTA contends that, at the very least, the adjustment made in the formula to account for common line demand growth under optional incentive regulation should provide LECs with no less incentive to increase carrier common line productivity than afforded by the price cap plan. USTA proposed an alternative formula that it alleges would provide strong incentives for LECs to encourage the growth of common line demand.[80]

60. Discussion. We agree that the formula for common line demand adjustment proposed in the NPRM would deny LECs any credit for growth in interstate common line demand. On the other hand, we find that the formula proposed by USTA would be overly generous. As we did with the price cap plan, we find that permitting LECs to share in the benefits of demand growth creates a significant incentive for greater efficiency. We therefore adopt the common line formula that uses the historical growth in common line minutes of use, divided by two to compute carrier common line rates. This approach represents a middle ground between the method applied currently to rate of return LECs and the method applied to price cap LECS. This approach shares the price cap concept of crediting the LEC with

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[77] In the case of Section 61.39 carriers that are average schedule companies, the use of the LEC's most recent common line settlements through the average schedules was proposed.

[78] NPRM (Erratum), 7 FCC Rcd 5501.

[79] AT&T Comments at 8-9.

[80] USTA Comments at 29; USTA Reply at 11-23, citing LEC Price Cap Order, 5 FCC Rcd 6786, 6794 (1990). But see AT&T Reply at 5 (USTA plan substantially reduces incentives to reduce costs and fails to give ratepayers the benefit of lower rates).

50 percent of the benefit of demand growth; however, it is not based on minutes per line, but is based on minutes alone, similar to the method currently used for rate of return carriers.

E. Eligibility and Optional Basis

61. Notice. The NPRM proposed that the incentive plan would be available to any non-price cap LEC that has exited the NECA pools. The plan would not be available to any company that participates in a multi-company tariff.[81] In addition, the NPRM concluded that any small and mid-size company incentive plan should be optional. However, carriers electing to file pursuant to the plan would have to participate for all their interstate rates.[82] The proposed rules would require average schedule companies to perform cost studies in support of rates filed pursuant to the incentive plan. Carriers electing the plan must remain under the plan for at least two years. If a carrier leaves the plan, it would maintain a company-specific tariff under Section 61.38 until the fourth year after the year in which it ceased its participation in the incentive plan.

62. Comments. The proposal that the incentive plan be available on an optional basis is supported by most commenting parties specifically and opposed by none.[83] Other parts of the proposal were more controversial.

63. USTA asserts that a LEC should be permitted to elect the optional incentive regulation plan for traffic sensitive rates while remaining a participant in the NECA common line pool.[84] USTA further states that only five non-price cap LECs do not participate in either NECA pool, while approximately 50 LECs participate in only NECA's common line pool.[85] USTA and AT&T argue that the primary goal of the plan should be to provide benefits of incentive regulation to the largest number of LECs possible, regardless of whether those LECs eventually move to price caps.[86] USTA further argues that a LEC's decision to continue in the NECA common line pool would largely be based on reasons

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81 NPRM, 7 FCC Rcd at 5027.

82 Id. at 5027.

83 Lincoln Comments at 8; PRTC Comments at 5-6; ITAG Comments at 2; GVNW Comments at 4; SBA Comments at 8-9; NTCA Comments at 5-7; OPASTCO Comments at 8.

84 USTA Comments at 5; see also Alltel Comments at 7-8; PRTC Comments at 2-4; PTI Comments at 3-4; JSI comments at 9; ITAG Comments at 7; GVNW Comments at 8; SBA Comments at 10; USTA Reply at 4-6.

85 USTA Comments at 6-7.

86 Id. at 8. AT&T Reply at 5-7; see also PRTC Reply at 2.

unrelated to the incentive plan and that other safeguards proposed would effectively preclude gaming or other abuse.[87]

64. MCI opposes bifurcation of the optional plan, citing the Commission's tentative conclusion that in order to maximize the benefits of an incentive plan, the company's total regulated interstate operations should be subject to the plan.[88] MCI contends that none of the comments favoring this form of optionality have adequately explained their positions. MCI argues that the LECs would have a financial incentive to report investments, expenses, reserves and revenues in a manner which would generate a traffic sensitive rate of return as high as possible. MCI states that if common line earnings suffer, the pooling process would "correct" these mythical earning deficiencies in the following year. MCI argues that this is merely an opportunity for LECs to increase total earnings without increasing efficiency.[89]

65. With respect to the provision allowing LECs to opt out of the incentive plan, USTA, and many of the commenting LECs, support the Commission's proposal that LECs be permitted to leave optional incentive regulation subject to appropriate safeguards, and that the proposed minimum two years in and four year out, will help ensure that LECs do not game the process by switching back-and-forth between the filing options.[90] USTA does request clarification that the proposal that a LEC must file "company-specific" rates when it leaves the incentive plan is not intended to deprive a group of affiliated telephone companies from filing a single tariff that is not an association tariff, as is now permitted under the Commission's rules.[91] USTA also argues that, to be consistent with current rules, a carrier leaving incentive regulation should be permitted to reenter, or enter for the first time, NECA's traffic sensitive pool. USTA argues that a requirement that the LEC cannot participate in the common line pool would be particularly severe in light of the proposal that the carrier cannot return to the incentive plan for four years.[92] USTA also argues that small LECs (carriers with less than 50,000 access lines) should be permitted to reenter both the common line and the traffic sensitive pool in order to ameliorate part of the risk faced by these companies due to their higher revenue variability.[93] ITAG states that companies should not be required to file tariffs

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87 USTA Comments at 10 (noting that the Section 61.39 small company rules apply only to traffic sensitive rates).

88 MCI Reply at 3.

89 Id. at 3-4.

90 E.g., USTA Comments at 24-25. See also Lincoln Comments at 8; but see Centel Comments at 10 (arguing that LECs should be eligible to return after two years).

91 USTA Comments at 25.

92 Id. at 25-26. See also PRTC Comments at 4-5.

93 USTA Comments at 26.

under the more burdensome Section 61.38 if they drop out of the optional incentive regulation plan, but should be permitted to file a Section 61.39 tariff or return to the NECA pools.[94]

66. The ICC asserts that carriers that elect to participate in the optional incentive plan should commit to participate for longer than two years. While the ICC agrees that this plan should be optional for non-price cap LECs, the ICC notes that it is unlikely that much will be learned about whether a LEC choosing this plan has increased efficiencies or made other gains in service quality in just two years.[95]

67. Discussion. We will permit carriers to elect to employ the incentive plan to set rates for either their total interstate operations, or for their traffic sensitive rates only, while participating in the NECA pools for other rates. This additional flexibility is consistent with our attempt to maintain the balance of risk and reward we seek to maintain in this proceeding. Moreover, given that this plan is grounded in rate of return methods, we are not as concerned as we were in the price cap proceeding that applying different methods to different rates would permit LECs to game the system. Attempts to cost-shift would be detectable in two ways -- through the biennial tariff review process, which requires a showing of cost by basket, and, for a few of the carriers likely to elect the plan, through ARMIS, and the Commission staff's performing trend analysis and comparing reports from several carriers to divulge anomalies.[96] NECA will also monitor claims for costs within the pools, as it does now for LECs. These protections offer reassurance that LECs will not be able to use these diverse regulatory methods to produce unreasonable rates. Furthermore, we are persuaded by the arguments of USTA and those carriers most likely to elect this plan, that this form of optionality will greatly encourage participation. Because we believe the optional incentive plan constitutes improved rate of return regulation that will yield dividends to ratepayers, encouraging maximum participation is important.

68. While we agree that a carrier that fully participates in the plan experiences the strongest incentives for efficiency, even partial participation is better than none. A company may rationally elect the plan for traffic sensitive rates initially, gain confidence in the new regulatory system, and later move its common line rates into the plan. Such action would be consistent with our broader scheme of giving smaller carriers a continuum of choices of regulatory alternatives. With regard to the carrier's incentive to manipulate its books of account, the biennial tariff review, ARMIS, NECA pool monitoring, and the complaint process provide sufficient opportunity for MCI or others to challenge the carriers accounting methods and to seek remedies for improper cost shifting.

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[94] ITAG Comments at 8. See also GVNW Comments at 4.

[95] ICC Reply at 7.

[96] The Commission's Automated Reporting Management Information System (ARMIS) is a database comprised of detailed cost and accounting information submitted by the larger LECS.

69. All commenting parties support the proposed optional nature of the plan. The optional character of our proposal is consistent with our recognition of the inherent diversity of the smaller companies. This optional feature also establishes the proper balance between meeting our regulatory responsibilities and a company's legitimate business needs. We therefore restate our commitment to maintaining the optionality of our regulatory alternatives for smaller carriers.

70. In the NPRM we proposed that carriers electing the plan be required to remain in the plan for only one two-year tariff period before they may exit the plan. We believe that requiring participation for a longer period, combined with adequate notice of the carriers intent to leave the plan will provide stronger protection against abuse. Therefore, we will establish four years, or two tariff periods, as the minimum for participation in the incentive plan. In addition, carriers seeking to exit the incentive plan must provide notice to the Commission, two years before exiting the plan.

71. We next address the rules governing a carrier's election to abandon the incentive plan. The proposed restrictions are intended to assure that the plan creates long term incentives for efficiency, not opportunities for short term profits through switching between different regulatory plans. We proposed to deter the latter by limiting the carrier's choices if it wishes to leave the incentive plan. Although the election is not permanent, a carrier leaving the plan may not return to the NECA pools and must maintain its own tariffs under Section 61.38 of our rules, or become subject to price cap regulation. ITAG and GVNW argue that companies serving 50,000 lines or fewer should be permitted to leave the incentive plan and file tariffs pursuant to Section 61.39. We do not find the arguments compelling and remain concerned that the choice might be abused; however, we would consider requests for waiver to permit small companies leaving the incentive plan to follow Section 61.39 upon a showing of good cause, that no windfalls or other abuses would occur.[97]

F. New Services

72. Notice. The NPRM sought to streamline the introduction of new services which help the small or mid-size LEC compete with a nearby price cap LEC for customers. Under the proposed rules new services would receive streamlined tariff treatment, including a presumption of lawfulness, if the anticipated earnings are *de minimis* and the rates do not exceed the rate charged by the geographically closest price cap regulated LEC offering comparable service. The NPRM proposed that *de minimis* would be defined as 2 percent or less of the company's total operating revenue. According to the NPRM, if these parameters are not met, the carrier would be required to file section 61.38 cost support

[97] We agree with USTA that our requirement that a LEC file "company-specific" rates when it leaves the incentive plan is not intended to deprive a group of affiliated telephone companies from filing a single tariff that is not an association tariff.